AUSTRALIAN ENERGY COUNCIL

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Dear Sam,

RPR0016 – Review into the arrangements for failed retailers' electricity and gas contracts

The Australian Energy Council (AEC) welcomes the opportunity to make a submission to the AEMC Review into the arrangements for failed retailer's electricity and gas contracts.

The Australian Energy Council is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers. The AEC recognises the existing Retailer of Last Resort (RoLR) framework was formulated and established under market conditions and with an industry structure that is very different from today. Indeed, there are several components to framework that warrant examination, including the wholesale cost burden for the RoLR after a retail failure. As such, the AEC welcomes this review and the opportunity to provide insight from its members into the review process.

1. *The nature of the problem*

The AEMC notes two broad drivers for exploring the issues identified in the review: systemic risk and the increase of costs to RoLRs and customers from retail failure.

RoLR events have traditionally been relatively uncommon. Prior to this year, there had only been 4 RoLR events over the period 2016-2021. However, in the past seven months there have been 7 RoLR events due to unprecedented wholesale market conditions and exacerbated by the reintroduction of retail pricing regulation. The AEMC refers to the need to safeguard against systemic risk in describing the problem, drawing similarities to the unprecedented conditions in the United Kingdom that led to the RoLR-equivalent of 26 energy retailers including the seventh largest retailer - Bulb Energy, which had 1.7m customers (6% market share). While there are some parallels to the Australian market, there are some notable differences. Only four Australian residential electricity retail licence holders have more than 6% residential electricity market share – one of which is Government owned.[1] Further, it would take the combined failure of 50 other retail licence holders to breach this 6% threshold.[2] Additionally, as the failure would be spread across the country, the additional hedging costs would likely be spread across all RoLRs.

In the extreme circumstance of an impending cascading financial collapse, any complex hedge contract transfer mechanism is unlikely to act sufficiently quickly. If the required conditions for systemic failure were to arise it would almost certainly require either the suspension of the market or direct Government intervention.

[1] Analysis based on National residential electricity customer number figures from AER Q3 2021-22 retail performance data. Excludes Victoria.
[2] Ibid.

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As such, the AEC is of the view that systemic risk is better dealt with through the development of a more holistic contingency plan, rather than any of the mechanisms considered in this paper. If systemic risk is to be considered further in this review, analysis should be done on the thresholds at which systemic failure is likely, to ensure the appropriateness of response options considered.

The second problem the AEMC identified was the wholesale cost impact to the designated RoLR and customers from retail failure. This cost impact occurs across all RoLR events and has been heightened with the re-introduction of price regulation through the Default Market Offer and Victorian Default Offer. Price regulation means that retailers will have to bear the financial burden of unhedged customers with every retailer failure. In the instance of multiple retailer failure as occurred earlier this year, this cost is amplified. The AEC is of the view that these costs can be material, and options that better support RoLRs to manage these wholesale costs should be investigated.

2. *Risks and costs for gas retailers*

The AEMC identified four broad issues with the current gas contract directions framework which could increase the cost for the designated RoLR and customers, namely:

- there is a high standard for direction;
- only 3 months are allowed to negotiate new terms of the contract;
- some adverse incentives for re-contracting; and
- the exclusion of storage contracts from the direction's framework.

The AEC is unaware of any additional issues with the current directions' framework, noting the limited incidents in which it has been used. The AEC is of the view that if there are efficiency improvements that could improve the gas directions process that this would likely reduce costs associated with a RoLR event.

3. *Assessment framework*

Given the broad and forward-looking nature of this review, a robust assessment framework is important to ensure appropriate bounds for a solution to be developed. The AEMC has proposed six key assessment criteria to guide this assessment. These criteria are relatively comprehensive, encompassing providing a strong guide to the assessment. However, the AEC notes a few additional elements that should be considered in definitions of these criteria. Specifically, the efficiency criterion should also consider:

- the risks of additional barrier to exit being created from any of the solutions – a well-functioning competitive market should support both market entry and exit and any solution that adds barriers to the general market exit should be thoroughly considered
- any unintended procedural or administrative costs or steps that a solution could create for the business-as-usual hedging process
- any increased prudential costs that may result as a part of the solution.

Finally, while this concept is touched on throughout the assessment framework, the AEC is of the view that there would be benefit of a specific criterion relating to the proportionality of response, ensuring that the solutions being considered are proportionate to the size and likelihood of the problem. For example, it would be an issue if the solution implemented had a created inefficiencies and unintended consequences that impacts the regular operation of the market.

4. *Option 1 – Cost recovery clarity*

The AEMC identified four potential options that could be used to address the electricity hedging costs and systemic risk from a RoLR event. The first option identified involves an expansion to the current RoLR cost

recovery mechanism administered by the AER, with the addition of an explicit wholesale or hedging cost recovery. This option would allow the RoLR to make a reasonable case for costs incurred and relieve the financial strain for on the RoLR. While the AER cost recovery process will take some time to complete, a specific provision to enable this cost recovery may assist the RoLR in securing finance for the 'high risk period'.

Given the simplicity and effectiveness in addressing the cost burden issue, the AEC is of the view that this option should continue to be considered into the later stages of the review.

5. *Option 2 – Matchmaking service*

The second option identified by the AEMC was the provision of a matchmaking service that would enable information on contracts held by the failed retailer pass to the RoLR via the AER, enabling the RoLR and the failed retailers' counterparty to negotiate a new contract.

While this option is straightforward and relatively transparent, it may not provide a significant benefit to the RoLR. Considering the retailer failure would likely occur at a time when the market conditions are tight, the failed retailers' counterparty would likely have significant demand for its contracts, and even if they were connected to the RoLR, they may simply list the contracts on the open market. The contract market is already relatively well functioning with brokers already serving as professional matchmakers, considering not only price, and quantity but also leverage and prudentials.

One of the few benefits of this approach is it would enable the RoLR to know which counterparties have available contracts and may speed up the re-contracting process. This may have merit, however consideration should be given to the types of information that is shared. For instance, if the RoLR already has contracts with the failed retailers' counterparty with vastly different terms, this could impact the relationship between the parties moving forward. As such, the AEC would only support the further consideration of this option if there is careful consideration of the information shared between participants.

6. *Option 3 – Introduce a directions framework*

The AEMC identified two variations of option 3, both of which involve immediate contract directions during a 'high risk period', and after this period is over the RoLR and failed retailers' counterparty must renegotiate contracts either with reference to the market price or the original contract price. This option is particularly complex, has the highest difficulty in implementation and likelihood of unintended consequences of all the options identified in the paper. Several issues with this option include:

- There are several technical complexities with contract novation, including the legal ability of the derivative contract to be directed to another party, the impact this has on the clearing houses and other prudential/margining mechanisms outside the NEM, the prudential and risk assessments between counterparties of the directed contract and the specific internationally recognised terms of standard contracts.
- It introduces an incentive for the failing retailer to sell their contracts ahead of their failure.
- The implementation of this method would result in the sharing of commercial-in-confidence contractual information between the failed retailers' counterparty and the RoLR, which may be detrimental to the counterparty.
- As the failed retailer would likely operate across several distribution networks/jurisdictions, there could be several RoLRs over which contracts would need to be divided – resulting a lengthy and complicated process.
- The defined 'high risk period' would be difficult to define and would likely change with each specific event and across jurisdictions.

If all these issues could be overcome, the one benefit of these options would be that it enables the immediate protection for the RoLR against wholesale/hedging costs. However, the importance of this benefit is minimised

if systemic risks are excluded from the problem statement. As such, the AEC does not support the further consideration of these options as the complexity and implementation issues outweigh its benefits.

7. *Option 4 – Use failed retailers' contracts to minimise cost recovery*

Option 4 builds on option 1 by utilising the revenue that could be generated from the sale of 'in the money' contracts to fund the cost recovery process. The implementation of this option would likely require changes to legislation outside of the energy sector including the Corporations Act 2001.

This option utilises profitable assets from the failed retailer to offset costs that would otherwise be borne by customers (as per option 1). While other creditors may also seek these assets, a case could be considered in prioritising public benefit as all energy market participants are supporting the provision of an essential service. Additionally, the revenue from the sale of these assets would be easier to divide across all the relevant RoLRs that incur costs.

However, there are a number of implementation issues that would need to be considered for this to be pursued, beyond change outside energy regulation. Consideration will need to be given to the impact the option on the integrity of the broader ISDA architecture, the risk implications of transferring funds form the failed retailers' counterparty to the RoLR and the speed of which value from the sale of contracts can be transferred to the RoLR. Additionally, this option will still need to overcome the incentive for the failed retailer to sell contracts ahead of failure.

Overcoming these issues may require a more sophisticated mechanism such as the AER acting as a middleperson between the bodies, awarding successful cost recovery amount as per option 1 in the first instance and then offsetting these costs with any recovered amount when they become available. While the AEC sees some merit in this approach it notes there are a number of issues that would need to be overcome if considered into the later stages of the review.

8. *Improving the current AER directions for gas supply*

The AEMC proposed five broad changes to the current AER contract directions framework, each change is considered below:

- Expanding AER directions to include gas storage contracts – As the AEMC notes in its consultation paper, the use of gas storage contracts was not common when the RoLR scheme was introduced and was not included. The AEC agrees that the inclusion of storage contracts into the directions framework would better support the RoLR manage the peak demand conditions that would likely occur during a RoLR event. As such, the AEC supports the further consideration of the inclusion of gas storage contracts under the existing contract directions framework.

- Broaden the trigger for RoLR gas directions to consider market conditions and pricing – The expansion of the directions trigger would change the nature of the directions framework to simply dealing with supply risk to reducing the wholesale costs of the RoLR, bringing it in line with the options considered for electricity in this review. The AEC supports further consideration of this option to broaden the trigger and reduce costs, as long as the trigger is a set at an appropriate level to reflect the magnitude of the issue.

- Increase directions power from three months to a 'longer period' – expanding the directions and negotiation time beyond three months does introduce the risk that the nature of the direction enters business-as-usual conditions. Noting the obligations to supply some industrial customers for up to 6 months the AEC would encourage stress testing of both 3- and 6-month options to identify a preferred outcome.

- Clarifying whether a direction should continue regardless of whether the contract expires during the direction period – This change would extend the directions framework to change the underlying terms of the contract. This would unnecessarily bind the failed retailers' counterparty to a contract that it may not be able to support. For instance, the gas shipper may have already sold contracts for gas supply

or pipeline capacity to a third party for the period outside the terms of the original agreement with the failed retailer, and this change would impact the contract with the third party. As such, the AEC does not support the further consideration of this option.

- Include the requirement that all entities in the direction to negotiate in good faith or with best endeavours to negotiate new contracts – Given the unusual circumstances over which these directions would be triggered, good faith or best endeavours provisions may be appropriate to avoid any extremely opportunistic behaviour. As such the AEC supports the inclusion of such provisions in the framework.

9. *Nature and materiality of the problem*

The AEMC has raised concerns about 'unusual retailer behaviour' that has been observed over the recent volatile market condition, including the

- rapid increases in customer offers with little notice
- assertive communications requesting customers to change retailers
- electricity retailers not appropriately hedging customer load thereby being exposed to large changes in wholesale prices
- significant and potentially speculative contract market activity by physical market participants

The AEC notes while the first two points may be perceived as unfair for customers, the bottom two points pertain to retailer hedging strategies. The AEC believes that it is important that retailers and other market participants maintain their right to adopt a hedging strategy of their choosing, noting it is already subject to the Retail Reliability Obligation (RRO) which obliges retailers to maintain a high level of cover. Hedging strategy is a fundamental role of a retailer and speaks to the effectiveness of the competitive market.

On the first two dot points, the AEC notes that while any behaviour that is unfavourable to customers should be avoided, there are already protections in Australian Consumer Law that should safeguard against any malicious activity. As such the AEC does not consider further exploration appropriate as part of this review.

Any questions about our submission should be addressed to Prabpreet Calais by email to Prabpreet.Calais@energycouncil.com.au.

Yours sincerely,

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